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SUBJECT: ARMENIA'S STEADY GROWTH, STABLE ECONOMY CONTINUES
IN 2005

1. (U) THIS CABLE IS SENSITIVE BUT UNCLASSIFIED. PLEASE
PROTECT ACCORDINGLY.

SUMMARY

2. (SBU) Armenia's steady economic performance continues during 2005. First quarter data supports the International Monetary Fund's (IMF) forecast of 8 percent GDP growth in 2005, and there are encouraging signs that growth is more broad-based than in the past. The government appears to be succeeding in its effort to raise tax revenues to support increased state-sector wages as well as social spending, key components of its poverty reduction strategy. Sharp increases in foreign investment and remittances from abroad have pushed the dram up against the dollar and Euro, worrying foreign investors and forcing the Central Bank into an awkward trade-off between controlling inflation and controlling sharp exchange rate increases. The dram's appreciation notwithstanding, indicators suggest a stable macroeconomic environment and steady but slow progress reducing poverty. End Summary.

MACROECONOMIC OVERVIEW: GROWTH REMAINS STRONG

3. (SBU) In the first quarter of 2005, Armenia's GDP growth remained strong (and in-line with forecasts) at 7.8 percent against the same period of 2004. As in the past three years, growth in construction (22.3 percent) drove the overall economic expansion. Construction spending totaled USD 43.6 million during the first quarter, of which 82 percent was privately financed. The World Bank financed only 9.3 percent of construction and the GOAM 6.3 percent, refuting the common but spurious assertion that donors alone drive Armenia's construction boom. In addition to construction, there are encouraging signs of a broad-based economic expansion. Industry showed strong growth (5.1 percent on average) in several sectors; the strongest growth was in electricity generation, bottled water production and distribution, tobacco production as well as mining and metallurgy.

EXCHANGE RATES FLUCTUATE

4. (SBU) Inflows of investment and a rapid growth in remittances caused the dram to appreciate sharply over the past 18 months, creating a complicated situation for Armenia's Central Bank. The dram rose 16 percent against the dollar (13 percent against the euro) during 2004 and an additional 10 percent (6 percent against the euro) since the beginning of 2005. Although the appreciation has not yet significantly hurt exports (see below), the Central Bank has intervened timorously in recent months to contain upward pressure on the exchange rate. The Central Bank has not, however, intervened strongly enough to reverse or stall the dram's rise for fear that large purchases of foreign exchange could cause an inflationary increase in the money supply. (Note: The IMF has come out publicly in support of the Central Bank's decision to allow the dram to appreciate rather than risk increased inflation. End Note.)

INFLATION CYCLICAL BUT STABLE

5. (SBU) Armenia's 4.4 percent inflation rate for the first quarter of 2005 illustrates the cyclical nature of Armenia's inflation. High consumer price inflation in January (a 5.4 percent increase on previous month) was followed by 0.7 percent and 0.9 percent deflation in February and March respectively. Because food makes up the greatest part of the consumer basket, higher prices for fish and meat brought inflation in January, and lower prices for vegetables in February and March drove the deflationary trend that typically continues through fall. The Central Bank

(reasonably) projects that it will meet its 3 percent inflation target, relying on Armenia's deflationary summer months and the appreciation of the Armenian Dram (which presumably makes imported food cheaper).

16. (SBU) The outlook for the producer price index was more ominous. Producer price indices in construction, sales, and agricultural sectors rose noticeably in the first quarter, by 15.2 percent, 7.9 percent and 7.3 percent, respectively, due largely to a significant price increase for non-ferrous metals (up by 62.7 percent). Increases in the producer price indices will likely have only a muted effect on the consumer price index, which comprises (largely imported) food and services.

FOREIGN TRADE EXPANDS

17. (SBU) Despite the appreciation of local currency, Armenia's exports and imports increased by 28 percent during the year's first quarter. The increase was due to substantial growth in exports to Germany (copper), Holland (diamonds), Israel (diamonds) and Switzerland and in imports from Russia, Belgium, and Israel (all diamonds). Although the diamond trade kept up its share of the growth in trade, non-diamond exports and imports also grew by 29.4 percent and 22.4 percent, respectively, albeit from a low base, to USD 134 million and USD 293 million.

WAGES UP, UNEMPLOYMENT DECREASING

18. (SBU) Average nominal monthly wages/salaries increased by 23.7 percent to AMD 47,564 (approximately USD 107) compared to the first quarter of 2004. In part this increase was driven by a 31.3 percent increase in public sector wages, but private sector wages rose 19 percent as well, despite the fall in nominal wages for the many employees whose paychecks are dollar-denominated. Also suggesting stronger demand for labor, the official unemployment rate fell from 9.4 percent to 8.9 percent the first quarter 2005. While the official unemployment rate grossly understates real unemployment (which was estimated to be 30 percent in 2001), when combined with the positive trend in wages it suggests that total unemployment is falling.

BUDGET REVENUES AND EXPENDITURES ARE UP

19. (SBU) According to first quarter data from the National Statistics Service, the government has succeeded in increasing tax revenues to support increases in social expenditures. Budget revenues for January-March 2005 were AMD 77,445 million (approximately USD 172 million), 36.6 percent higher than the same period last year and tax revenues increased to 15 percent of GDP. Government expenditures also rose 31.5 percent. While defense still claimed the largest share of expenditures at 17.7 percent (up 2 percent from 2004), education and science received 15.4 percent (also up 2 percent from 2004) and social insurance 15.9 percent (up 4 percent).

COMMENT: ARMENIA FULFILLING POVERTY REDUCTION STRATEGY

10. (SBU) As Armenia's economy continues its steady growth, the government of Armenia has taken steps to implement its Poverty Reduction Strategy Paper, the government's de facto economic development strategy. The GOAM maintains macroeconomic stability by keeping a prudent monetary policy and a free-floating exchange rate. Although the dram's appreciation affects many in Armenia who have dollar-denominated contracts, it has not yet hindered the growth of Armenia's exports, which often have dollar-denominated inputs. While both foreign investment and domestic growth continue, the State Tax Service has been able to increase tax collection which has translated into increased spending on public wages (such as teachers and hospital workers, many of whose salaries are below the poverty level) and social welfare.

EVANS